United States Court of Appeals

for the Second Circuit

PETITION FOR REHEARING EN BANC

74-1694

United States Court of Appeals
FOR THE SECOND CIRCUIT

TITAN GROUP, INC.,

Plaintiff-Appellant,

against

HAROLD FAGGEN,

Defendant-Appellee.

No. 239, September Term, 1974

Argued October 25, 1974

Decided April 1, 1975

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P/S

PETITION FOR REHEARING AND FOR REHEARING *EN BANC*

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PETITION FOR REHEARING AND FOR REHEARING *EN BANC*

Preliminary Statement

The Court has affirmed a judgment to Harold Faggen ("Faggen") of $5,500,000 plus accrued interest for acquisition of his actuarial consulting business in 1968, and affirmed dismissal of a Rule 10b-5 claim for material omissions in connection with his sale of such business to Titan Group, Inc. ("Titan"). Rehearing and rehearing *en banc* is justified because the decision is in direct conflict with a January 13, 1975 decision by another panel in *Metro-Goldwyn-Mayer, Inc.* v. *Ross*, Dkt. No. 73-2271, Slip. op. at 1315. With due respect, the decision herein has turned the law of omissions in Rule 10b-5 cases upside down, by rejecting the objective "reasonable man" test of materiality, established in many cases, to substitute a subjective test of investment motives to be applied by a trier of fact. The refusal to apply *Affiliated Ute Citizens* v. *U.S.*, 406 U.S. 128 (1972), has reversed several controlling precedents, and as a result, Titan is being ordered to pay $6.5 million for a business on the verge of liquidation for less than $150,000 (p. 27, Reply Br. for Appellant, updated to the present).

I. Omissions Which Are Material As A Matter Of Law Cannot Become Immaterial By Other Circumstances.

The ruling principle of Judge Waterman's Decision is:

"The case is not an appropriate one, in which to find materiality in the light of all the circumstances. This is a case both of alleged misrepresentations and of alleged material omissions. We view Judge Tyler's findings as determining that there was an abundance of evidence of the matters the plaintiff really considered important in entering this face to face transaction, that while the omissions might, in other circumstances, have been deemed material, the omissions were not material in these circumstances.

These findings were not clearly erroneous, and correctly applied the applicable law" (p. 2670, Slip op.).

We submit that this is not applicable law—if an omission is material by the litmus test of the "reasonable investor", it remains material regardless of the circumstances.

The omissions involved are, *inter alia,* the non-disclosure of a shrinking business—that 10% of the clientele of the Faggen consulting business had gone elsewhere before the acquisition closed. This loss of business with overhead remaining the same was bound to adversely affect 1969 earnings by as much as 20%. There was no disclosure that the biggest single client was lost in 1968, and that other key groups of clients were beginning to be lost before the acquisition closed, with reasonable probability of additional related clients being lost subsequently. Faggen supplied in his selling memo a written list of 143 clients, identifying 18 new ones between 1966-1968. In fact, 12 were already lost in 1966-68, six more were known to be in jeopardy and a disgruntled employee controlled 32 other clients—which he took with him right after the acquisition in December, 1968. A similar undisclosed alienation of clients had already occurred early in 1968. Ex. 19 (Jt. Appendix ("A") 1396-1398) shows a $386,922 shrinkage (40%) in the $1 million gross actuarial business of the Faggen Companies between 1966 and 1973, and most of this lost revenue and lost profit (because overhead did not go down) centered around $103,000 in annual billings (10%) lost by June 30, 1968, $90,000 more in jeopardy by October 1968 (9%), and the last $109,000 (11%) lost right after the closing in December, 1968. See pp. 31-38, Brief for Appellant ("Br. App.") for details.

The foregoing was a *material* omission, because "All that is necessary is that the facts withheld be material in the sense that a reasonable investor *might have considered them important* in the making of this decision." *Affiliated Ute, supra,* 406 U.S. at 153-154, quoted and applied in

Shapiro v. *Merrill, Lynch, etc.*, 495 F.2d 228, 240 (2d Cir. 1974).

The decision rejects this undisputed omission and the ruling test of materiality.[1] *Metro-Goldman-Mayer* v. *Ross supra,* on a legally identical omission reached exactly the opposite result (by Judges Hays, Smith and Mansfield). First, the M-G-M case involved a Rule 10b-5 claim arising from a face-to-face private acquisition, as herein. Second, a long-form acquisition agreement with detailed representations and warranties was involved, but a claim of fraud under Rule 10b-5 *outside* the contract was also made, as herein. Third, the accountants for M-G-M (Arthur Andersen & Co.) made a detailed "purchase investigation" over several months, much more thorough than Titan made of Faggen. In M-G-M, their accountants came up with revised net worth figures far below those represented, finding overstatements which were clear warning of others. Yet, notwithstanding this investigation, the seller was still held liable in M-G-M for omitting to disclose that which a more thorough investigation would have turned up:

"[There were] representations made by Ross employees that the Ross companies followed the common practice of providing to distributors three so-called free records for every 10 single records purchased and two free records for every 10 albums . . . In its claim for rescission, M-G-M relies primarily on the failure of the Ross brothers to inform it of some 70,000 records which the Ross companies had given to distributors free of charge, over and above the usual three on 10 and two on 10 arrangements, which M-G-M had been told was in force . . .

"The district court's conclusion that there had been no violation of a duty to disclose was based in large part on the fact that during the purchase investigation the Ross companies provided Arthur Andersen with inventory cards which, if explained and interpreted properly, could have

[1] It also ignored financial omissions discussed *infra.*

revealed all but 12,500 of the 70,000 additional records. However, Rule 10b-5, as well as the terms of the exchange agreement, required the Ross brothers to state all material facts necessary to make other statements not misleading . . . Such a duty is not discharged merely by giving the purchaser access to company records and letting him piece together the material facts if he can. . . .

"In concluding that the Ross brothers had satisfied their duty to disclose, the district court also relied on evidence that . . . M-G-M Records knew that some additional records were being distributed free of charge by the Ross brothers and that M-G-M and industry practice was to distribute some no-charge records beyond the three on 10, two on 10 standard. However, in light of the statements by Ross employees that free records were distributed on a three on 10, two on 10 basis, M-G-M was entitled to a full disclosure that large numbers of additional records were being distributed free of charge."

Faggen's presentation of a "bullish" list of 143 clients is legally identical to the Ross Bros. disclosure of its free record policy. So is Faggen's omitting to disclose the shrinking clients, just as the Ross Bros. omitted to disclose their additional free records. Both omissions involved a material reduction in future revenues and profits. Circumstances of M-G-M knowing "some additional records were being distributed free" and M-G-M's own policy and industry practice, were all held irrelevant, as were circumstances of an intensive accounting investigation before the closing. M-G-M is controlling precedent, neither followed nor distinguished herein.

An unsound analysis underlies the decision herein in holding, in effect, that in a mixed case of misrepresentations and omissions, reliance on both the false statements and separate reliance on the deceptive omissions must be factually proven. We believe that this is not the law, with all due deference. There is no basis in precedent or prac-

tical common sense to have one rule of law for pure omissions, and another for omissions diluted by misstatements. The *Affiliated Ute* principle of constructive reliance inferred from a genuinely *material* omission has to apply in all cases under 10b-5(2). If the plaintiff presses only affirmative misstatements, he must show reliance in fact, and Judge Tyler's factual determination (albeit believed erroneous) "of the matters the plaintiff really considered important" might be controlling.[2] But if plaintiff presses an omission too (and it only takes a single substantial omission to prevail under Rule 10b-5), then the principle of causation implied from materiality applies to the omission branch of his case. How can the Court give buyers the impossible burden of proving "reliance" on that which they never knew? The cited cases all base "constructive reliance" on the impossibility of proving reliance in an omission situation. The erroneous principle used herein further makes it advantageous to provide a great deal of false data in selling material to blur the impact of a single important omission—such as a shrinking business. *M-G-M* v. *Ross, supra,* is a typical example of a mixed question of misrepresentations (over-stated receivables) and material omission (undisclosed free records policy), where the omission alone, and its materiality, were all that were required in a face-to-face acquisition transaction. Moreover, the face-to-face distinction suggested in the decision herein is irrelevant, because *Affiliated Ute* was a face-to-face fraud and is so described in *Shapiro* v. *Merrill, Lynch, etc.,* 495 F. 2d at 240; the constructive reliance doctrine originates in face-to-face omissions, and "that rule is dependent not upon the character of the transaction—face-to-face versus national securities exchange—but rather

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[2] We do not again mention the ample proof of reliance discussed in Br. App. 48-52, nor the anomaly in saying the buyer of a business with only $1.6 million net worth was willing to pay $5.5 million and did not care what its earnings were, and would not care if they were dwindling.

upon whether the defendant is obligated to disclose the inside information". *Chris-Craft Industries* v. *Piper Aircraft Corp.*, 480 F. 2d 341, 376-377 (2d Cir. 1973), cited herein also involved both misstatements and omissions to disclose, as did *M-G-M*.

The decision accepts these ruling cases, but then contradicts them by an invalid distinction. *Affiliated Ute* is characterized as an instance of "total non-disclosure," when it too was a mixed package; 406 U. S. at 152, "the record reveals a misstatement of a material fact, within the proscription of Rule 10b-5(2), namely, that the prevailing market price of the UDC shares were the figure at which their purchases were made." *Bromberg, Securities Law,* ¶ 2.6(2) points out (cited in *Ute* at 154), "Clause 2 [of Rule 10b-5, false statements and omissions], by its own terms, operates only if some statement is made, and this outlaws half-truths and other forms of partial silence or failure to disclose." An omission to state a material fact necessary to make other statements not misleading always requires other statements to have been made. Faggen's list of clients is just such statement that became deceptive because of his omission to disclose lost clients. So too was the omission in *M-G-M* superimposed on a statement of free record policy. There is no such animal as an instance of "total non-disclosure" upon which to apply Rule 10b-5(2).

The holding herein is that a weighing by the trier of fact of what "the plaintiff really considered important" should control, even though there has been a substantial omission. But by definition, an omission means plaintiff did not have the opportunity to weigh it in his investment analysis; so how can the trier of fact weigh it for him? An omission cannot be material in some circumstances, but immaterial because plaintiff's attention was directed at other factors. It is just this diverting of a buyer's attention away from a material adverse business item that he "might have considered important" (the *Ute* test),

that makes it impossible to use what he *does know,* to dissipate the conceded importance of what he *does not know.* Once an omission is found to be material by the objective tort law test of the "reasonable investor," all his presumed other motivations are under a cloud of deception. The theory of an objective test is that full knowledge might change his mind, and the investor should have the right to make that decision himself. Constructive reliance is not a mere procedural tool to allow proof more easily, but reflects a substantive determination of how people are "taken" in securities transactions, by what they do not know. If a reasonable man might attach importance to the fact omitted, it is material and it remains material. Materiality is not a transitory concept, akin to a rebuttable presumption; it is the substantive foundation of any case under 10b-5(2). Analysis ends with the litmus test in *Ute* and *Schapiro,* not subject to the visceral attitude of a trier of fact as to what "really" mattered five years before. In these types of transactions, it is hard facts, stated and unstated, that must control, not judicial reconstruction of acquisition attitudes in 1968. That is a function of Wall Street historians, and Judge Tyler's hypothesis notwithstanding, there were some acquirers in 1968 who cared about earnings. The attempt herein to reconcile the District Court's disregard of *Ute* erects an impossible doctrine —that mixed questions of false statements and omissions can never come under *Ute,* when nearly all cases are such mixed questions. It supplants objective materiality with "circumstances," i.e., acquisition intuitions by triers of fact. How can an appellant panel apply a "clearly erroneous" standard of review, to an intuitive determination by a trial judge of why a buyer "really" bought a company, which necessarily determined *nothing* could change the buyer's mind? Judge Tyler has held that no matter what Faggen might have said about lost clients or illusory earnings adjustments, it could not have changed Titan's decision to invest. Can such a far reaching determination ever be reviewable, much less be logical? An objective, non-

circumstantial test of materiality is absolutely required in both pure and mixed omissions cases for the guidance of juries, judges and the bar. Those who seek to comply with 10b-5(2) have to know, in advance by a clear test, what is material and what is not material. Such matters cannot be left to a reading of circumstances. A conflict between panels in the same Circuit is sound reason for correcting the principle now. See *Supt. of Insurance* v. *Bankers Life and Casualty Co.*, 404 U.S. 6, 10, ftn. 7 (1972).

II. The Determination That the Income Statement Herein Is Not A Financial Statement Is Contrary to Fact and Law.

Titan supplied a body of accounting principles of disclosure with which Faggen failed to comply in stating "Net Income" for the years 1965-68. The opinion dismisses them in a footnote, "The income statement is clearly only a presentation of rough bottom line figures and not a financial report to which accounting principles and rules apply." But the income statement is far from rough, supplying dollar figures in precise detail (p. 12, Br. for App.),

"Totals .. $380,802 $490,754 $451,885 $571,262,"[3]

with further breakdowns by each corporation and date of fiscal closing. Moreover, only "bottom line" income figures were given because the "top line" revenue and expense figures were separately supplied in precise detail by certified public accountant Faggen in his four years of tax returns given to Titan. His exact sales figures (cash basis receipts) that led to these bottom line income figures were well known and discussed by the Titan Board (A1344, 975, 1382, 390-391). The opinion ignores this background to the Selling Memo which made it a financial re-

[3] Since when can even rough figures be deceptive by not being adequately explained? Can any important statement of fact, numerical or otherwise, be allowed to pass with material omissions?

port subject to disclosure requirements. Can a seller of securities evade his duty to disclose merely by dividing up his numerical presentation into three sets of papers—1) tax returns, 2) adjustments in detail for 1968 and 3) adjusted income for 1965-1968? The testimony is undisputed that Titan's negotiating officers read them together.

The Court excludes all disclosure accounting principles from this case. What then may be deemed to be a financial statement or a financial representation requiring full disclosure, for purposes of Rule 10b-5? *Bromberg, supra,* ¶ 7.4(2), p. 168.1, treats bottom line earnings information as a material disclosure item, without any supporting numerical data—sales, expenses, etc. "Earnings information becomes more material with the length of the period it covers [herein, it covered 4 years], and with the variation in result from the prior corresponding period." See *Bowman & Bourdon, Inc.* v. *Rohr,* 296 F. Supp. 847, 849, 851 (D. Mass. 1969), affd. p.c. 417 F. 2d 780 (1st Cir. 1970), where the defendant's inventory report *alone,* without explanation of certain questionable assumptions, resulted in liability. The unexplained inventory count and pricing were deceptive as they went into the accountant's financial report. In *Royal Air Properties* v. *Smith,* 312 F. 2d 210, 212 (9th Cir. 1962), the deceptive financial presentation in a face-to-face transaction was a "Land Use Analysis-Proposed Development Plan", with "estimates of profits and of return to investor", omitting to describe the cost of the land or mortgage requirements. Financial representations much less detailed than Faggen's have been the basis for liability in the cited cases.

In re Greenberg, 46 F. Supp. 289, 291 (E. D. N. Y. 1942), held that a mere *letter* to a bank stating that a bankrupt was building an apartment house, had a tentative mortgage commitment, and owed less then $1,000, was a financial statement. "Those were the documents on which he desired the bank to rely and they were his representations of his financial condition, and viewed from any stand-

point, constitute a financial statement for the purposes he had in mind." A similar functional definition of financial statement should be applied to Faggen's earnings presentation. Moreover, disclosure obligations apply to any factual statement, whether called a financial statement or not. The omitted financial disclosures thus fall under *Affiliated Ute*.

III. The Refusal to Apply Compensatory Damage Principles Was an Injustice.

In imposing damages seven years early for the accelerated $5.5 full face amount of what were concededly $3.2 million in cash value of ten-year convertible securities traded to Faggen, the Court has ignored the solid line of authorities throughout the country disallowing as an "unenforceable penalty" that portion of the notes which are unearned interest or unearned return on investment. See *Northtown Theatre Corp.* v. *J. J. Mikelsen*, 226 F. 2d 212, 214 (8th Cir. 1955); *A-Z Service-center, Inc.* v. *Segall*, 334 Mass. 672, 138 N.E. 2d 266 (S. Ct. Mass. 1956) and pp. 55-59 Br. App. If the conversion rights had any value to Faggen, he would not have accelerated; he would have held for seven more years and converted. This holder lost none of his options and profited solely from a lawsuit. The acceleration clause herein has exacted an unenforceable "penalty with a vengeance." *Minn. Billiard Co.* v. *Schwab*, 190 N.W. 836, 838 (Wis. 1922).

CONCLUSION

Rehearing or rehearing *en banc* should be granted.

Respectfully submitted,

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April 13, 1975.

Certification of Good Faith.

I, LAWRENCE M. POWERS, one of the attorneys for Petitioner, hereby certify that I have examined the foregoing petition and that in my opinion it is well founded and entitled to favorable consideration of the Court and that it is not filed for the purpose of delay.

LAWRENCE W. POWERS

(57877)

Due and timely service of Two copies

of the within PETITION is hereby

admitted this 14TH day of APRIL 1975

....
Attorney for APPELLANT